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No.

IN THE
Supreme Court of the United States
OCTOBER TERM, 1981

GLEN CORPORATION, *et al.*,
Petitioners,
v.
O.C. ASSOCIATES, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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July 19, 1982

QUESTIONS PRESENTED

1. Where the right to payment of interest on interest is barred by governing state law regardless of the debtor's solvency, is there an overriding "general rule of federal bankruptcy law" creating a right to payment of such interest in bankruptcy if the debtor proves solvent.

2. Even if there is such a "general rule of federal bankruptcy law," does that rule require the payment of post-petition interest on each unpaid installment of interest that becomes due during a bankruptcy proceeding.*

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* The following were parties to the appeals below: Glen Corporation, Monte J. Wallace, Neil W. Wallace, Paul Lazzaro (Trustee of Continental Investment Corporation), Minority Stockholders' Committee of Continental Investment Corporation (appellees); O.C. Associates, Debentureholders Protective Committee of Continental Investment Corporation, The First National Bank of Boston, as Indenture Trustee, and Bankers Trust Company, as Indenture Trustee (appellants). Glen Corporation has no partially-owned subsidiaries or affiliates. Global Investments Limited Partnership owns the preferred shares of Glen Corporation. Global Investment Limited Partnership has one partially-owned subsidiary, ConVest Energy Corporation.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Glen Corporation, Monte J. Wallace, and Neil W. Wallace (the majority shareholders of Continental Investment Corporation), and the Minority Stockholders' Committee of Continental Investment Corporation, respectfully petition for a writ of certiorari to the United States Court of Appeals for the First Circuit to review that court's judgment of April 30, 1982, in *O.C. Associates v. Continental Investment Corp.*, No. 81-1743; *Debentureholders Protective Comm. of Continental Investment Corp. v. Continental Investment Corp.*, No. 81-1741; and *Bankers Trust Co., Indenture Trustee v. Continental Investment Corp.*, No. 81-1756.[1]

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[1] Review has not been sought with respect to a fourth related case, *First National Bank of Boston, Indenture Trustee v. Continental Investment Corp.*, No. 81-1742. *See* note 4 *infra*.

OPINIONS BELOW

The opinion of the court of appeals is not yet officially reported and appears as Appendix A to this Petition. The order of the district court from which appeal was taken and the district court's Memorandum Opinion, which is also unreported, appear as Appendix B.

JURISDICTION

The judgment of the court of appeals was entered on April 30, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1976).

STATUTES INVOLVED

This case involves Sections 63a and 221(2) of the former Bankruptcy Act, 11 U.S.C. §§ 103(a), 621(2) (1976).

STATEMENT OF THE CASE

This appeal involves the relationship between federal bankruptcy law and the laws of numerous states that govern contracts providing for the payment of interest. The contract at issue in this appeal was governed by New York law, which explicitly bars enforcement of agreements to pay interest on unpaid installments of interest not already due at the effective date of the agreement. Despite finding that New York law barred the payment of such interest, the court of appeals ordered the award of interest on both pre-petition and post-petition unpaid installments of interest, basing its order on an overriding "general rule of federal bankruptcy law."

This case arises out of the reorganization under Chapter X of the Bankruptcy Act ("the Act") of Continental Investment Corporation ("CIC").[2] In October 1970 CIC

[2] The initial petition for arrangement under Chapter XI was filed in April 1976. On November 6, 1978, Congress enacted the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, which provided that a new Bankruptcy Code would apply to cases

issued 9 percent per annum convertible subordinated debentures in the aggregate face amount of $30 million due on November 1, 1990. In April 1973, CIC offered a new issue of straight debentures, due on November 1, 1985, in exchange for the outstanding convertible debentures. The straight debentures also bore interest at 9 percent per annum. The holders of the convertible debentures were initially offered a 30 percent premium, $1,300 principal amount of straight debentures for each $1,000 principal amount of convertible debentures; this premium was later increased to 40 percent, and most, but not all, of the convertible debentures were exchanged for the straight debentures.

The provisions of the indentures that gave rise to this appeal provided that different state laws would govern the respective debenture issues. The indentures for both issues provided that, in the event of default, the principal and any then-unpaid installments of interest would become due upon demand. They also provided that while interest would be paid on the principal, interest on any unpaid installments of interest would be due only "to the extent permitted by law." But by explicit provision in the indentures, the "law" governing the 1970 convertible debentures "for all purposes" was the law of Massachusetts; that governing the 1973 straight debentures "for all purposes" was the law of New York. *See* App. A at 3a-4a; Court of Appeals' Joint Appendix ("J.A.") at 256, 353.

Both indentures provided for semi-annual payments of installments of interest, with the principal due in a lump sum on the maturity dates. CIC failed to pay the installments of interest due on both issues of debentures on November 1, 1974, and thereafter failed to make any interest payments. Both indentures permitted the in-

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commenced on or after October 1, 1979. As discussed in Section IV below, the issues raised by this appeal apply both to the many cases currently pending under the Bankruptcy Act and to cases filed under the new Bankruptcy Code.

denture trustee to demand immediate payment of the full amount of principal and all accrued and unpaid interest following such a default. (J.A. 214-15, 311.) Notwithstanding these provisions, neither trustee demanded payment or commenced suit to collect any amount owing thereon, so neither issue of debentures was accelerated. A year and a half later, on April 30, 1976, CIC filed its petition for arrangement under Chapter XI of the Act. That proceeding was converted to a Chapter X reorganization in March 1978.

The reorganization of CIC proved to be a major success, allowing all creditors to be paid in full with the balance to be paid to the shareholders.[3] On June 5, 1981, the trustee for CIC submitted his Third Modified Plan. The plan provided for payment in full, in cash, of each debentureholder's allowed claim. The trustee proposed to pay both the full face amount of the principal of the debentures and all unpaid and accrued installments of interest up to the date of proposed payment, but did not provide for payment of interest on the unpaid installments of interest.

On June 18, 1981, the district court issued a decision approving the trustee's plan but reserving decision concerning the payment of interest on the unpaid installments of interest (J.A. 429); no appeal was taken from that decision or from the district court's order confirming the plan. In an opinion dated September 9, 1981, the district court found that there was good cause to deny payment of the additional amounts representing interest on all unpaid installments of interest. With respect to the small amount of debentures governed by Massachusetts law, the district court found that while Massachusetts law permitted agreements to pay such interest, payment

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[3] There are approximately 4,000 public shareholders of CIC. *See* Opposition of the Minority Shareholders' Committee to Claims of the Debentureholders, filed in the district court, at 4. The shareholders will realize approximately $40 million from the reorganization of CIC. (J.A. 430.)

of the full amount of principal due the debentureholders nine years before the final maturity date satisfied the requirement that the plan be fair and equitable. With respect to the far larger amount of debentures governed by New York law, the district court concluded that because New York law clearly barred any right to interest on unpaid installments of interest, no such payments would be allowed under the plan.

The briefs on appeal to the United States Court of Appeals for the First Circuit made diverse arguments on behalf of the New York (*i.e.*, straight) debentureholders.[4] The Debentureholders Protective Committee argued[5] that the contractual provision for interest on interest was valid under New York law and entitled the debentureholders to interest on all overdue installments of interest, including both those matured at the time of the petition and those maturing post-petition. The Indenture Trustee and O.C. Associates, representing the bulk of the straight debentureholders, abandoned any claim to interest on interest based on state law, arguing instead that federal bankruptcy law entitled the debentureholders to interest on installments of interest already overdue when CIC filed its Chapter XI petition ("interest on pre-petition interest").[6] They made no claim, however, that federal law entitled the debentureholders to interest on installments of interest falling due post-petition ("interest on post-petition interest").

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[4] The convertible debentureholders also appealed and won reversal. Because those debentures were governed by Massachusetts law, which does allow contracts for interest on future unpaid installments of interest, that case is not the subject of this petition.

[5] Brief of Debentureholders Protective Committee at 4-14, in 81-1741.

[6] Brief of Bankers Trust at 8; Brief of O.C. Associates at 21, in 81-1756 and 81-1743, respectively. O.C. Associates, which holds almost 60 percent of the straight debentures, acquired those debentures after the filing of the petition in bankruptcy (J.A. 369-70). The general partners of O.C. Associates are an affiliate of the Charter Company and an affiliate of Oppenheimer & Co. *Id.*

Of the five possible categories of interest arising under these debentures, two (pre-petition and post-petition interest on principal) were not before the court because the debentureholders' entitlement under state law had not been disputed. The court of appeals, in an opinion by Judge Wyzanski, denied a third category (pre-petition interest on unpaid pre-petition interest) as barred by state law and, because pre-bankruptcy, not within any entitlement under bankruptcy law. The court held that the fourth possible category, post-petition interest on unpaid pre-petition interest, was a matter of federal bankruptcy law. The court proceeded to award this interest because it asserted that a "general rule of federal bankruptcy law" established the right to payment of post-petition interest on claims, even though it also held that the debentureholders were not entitled to such interest under governing state law.[7] Finally, the court held that the debentureholders were entitled to post-petition interest on post-petition interest (that is, on interest installments that became due after the debtor filed its petition in bankruptcy). The court based this right not on state law, as had been argued by the one debentureholder rep-

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[7] The court described the contention that New York law permits recovery of interest on interest as "devoid of merit," App. A. at 14a, citing the leading case of *Young v. Hill*, 67 N.Y. 162 (1876), as well as *Newburger-Morris Co. v. Talcott*, 219 N.Y. 505, 510, 114 N.E. 846, 847 (1916) ("The rule is settled that a promise to pay interest upon interest is void if made at a time before simple interest has accrued") (Cardozo, J.); *Giventer v. Arnow*, 37 N.Y.2d 305, 308, 333 N.E.2d 366, 368, 372 N.Y.S.2d 63, 66 (1975) (same); *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 171-76 (1946) (citing *Talcott* at 510 and lower court's opinion) (Frankfurter, J., concurring); *Empire Trust Co. v. Equitable Office Bldg. Corp.*, 167 F.2d 346, 348-49 (2d Cir. 1948) (promise to pay interest on overdue interest coupons is void under New York law) (Swan, J.). *See also Williamsburgh Savings Bank v. Town of Solon*, 136 N.Y. 465, 481, 32 N.E. 1058, 1062 (1893); *Levine v. U.N. Cleaners*, 4 A.D.2d 954, 167 N.Y.S.2d 801, 802 (App. Div. 1957).

resentative claiming such interest, but rather on overriding federal law.

The court of appeals also held that the absolute priority rule required, in the circumstances of this case, that the plan of reorganization could not award any payments to the shareholders unless it compensated debentureholders for each of the categories of interest payments to which the court found they were entitled. It therefore reversed the district court's decision.

REASONS FOR GRANTING THE WRIT

I. THE COURT OF APPEALS' DECISION THAT A "GENERAL RULE OF FEDERAL BANKRUPTCY LAW" ESTABLISHES A RIGHT TO INTEREST ON INTEREST EVEN WHERE STATE LAW BARS ITS PAYMENT IS CONTRARY TO THE DECISIONS OF THIS COURT AND IMPROPERLY OVERRIDES GOVERNING STATE LAW.

The court of appeals overturned the decisions of the trustee and the district court because it concluded that a plan of reorganization of a solvent debtor could not be "fair and equitable" within the meaning of Section 221 (2) of the Bankruptcy Act if it failed to provide for the payment of post-petition interest on all unpaid pre-petition and post-petition installments of interest. The court concluded that the right to such payment arose from an overriding "general rule of federal bankruptcy law" providing for interest even where there is no right to that interest under governing state law. There is no such "general rule" and none of the cases cited by the court of appeals supports the court's decision. This Court should grant certiorari because the court of appeals' unprecedented decision is contrary to numerous opinions of this Court and improperly intrudes on contractual relations governed by state law.

A. The Cases Relied Upon by the Court of Appeals Clearly Establish That Applicable Non-Bankruptcy Law, Not Bankruptcy Law Itself, Determines Any Right to Post-Petition Interest on Unpaid Installments of Interest.

The court of appeals recognized that this Court has held on a number of occasions that post-petition interest on claims usually is not allowed under federal bankruptcy law. App. A. at 10a. Post-petition interest may be allowed, however, where, as here, the debtor proves solvent. The court of appeals read the cases recognizing this "solvency exception" as supporting an overriding "general rule of federal bankruptcy law" creating a right to payment of interest even where applicable state law bars the payment of interest. The cases cited by the court show, however, that the only general federal rule is that where a debtor proves solvent, bankruptcy courts may enforce a right to interest arising under applicable non-bankruptcy law.

The only opinion of this Court cited by the court of appeals in support of the existence of its "general rule" is *City of New York v. Saper*, 336 U.S. 328 (1949). App. A at 15a. In *Saper* this Court held that post-petition interest would not be allowed on tax claims against a bankrupt because of the "long-standing rule against post-bankruptcy interest. . . ." 336 U.S. at 332. The holding in *Saper* clearly provides no support whatsoever for the decision below.

The court of appeals presumably[9] sought support in this Court's footnote 7 in *Saper*, which said:

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[8] In fact, this Court observed there that "there is no interest except that which accrues according to law, . . ." *id.* at 331-32, and the claim to interest in *Saper* arose not from bankruptcy law, but from federal and state tax law, *id.* at 340 n.18; *Saper v. City of New York*, 168 F.2d 268, 269 (2d Cir. 1948), *aff'd*, 336 U.S. 328 (1949).

[9] The citation of *Saper* as authority for the "general rule" referred to no particular part of that opinion, App. A at 15a; the only citation of *Saper* with a specific reference was to footnote 7, *id.* at 11a.

> "Two exceptions [to the rule against post-bankruptcy interest] were recognized: if the alleged 'bankrupt' proved solvent, creditors received post-bankruptcy interest before any surplus reverted to the debtor, *Bromley v. Goodere*, 1 Atk. 75; *Ex parte Mills*, 2 Ves. Jr. 295; *Ex parte Clark*, 4 Ves. Jr. 676; . . . . These exceptions have been carried over into our system. See *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 267 . . . ."

This footnote, however, stands for nothing more than the proposition that *if* the creditor is otherwise entitled to interest under applicable nonbankruptcy law, *then* the creditor may receive that interest if the debtor turns out to be solvent. It creates no overriding "general rule of federal bankruptcy law" transforming a noninterest-bearing claim into a right to interest, as analysis of the cases this Court cited makes clear.

Bromley v. Goodere, 1 Atk. 75, 26 Eng. Rep. 49 (1743), the leading English case on interest payments in such circumstances, held only that where debts are interest-bearing by a valid explicit contract, creditors of a bankrupt's estate are entitled to post-bankruptcy interest before any surplus reverts to the debtor. *Ex parte Mills*, 2 Ves. Jr. 295, 30 Eng. Rep. 640 (1793), stands for the same proposition (it explicitly approved the decision in *Bromley*) and extends it to implied contracts for interest. And *Ex parte Clark*, 4 Ves. Jr. 677, 31 Eng. Rep. 349 (1799), simply held that one group of creditors was not entitled to be paid interest until after another group of creditors had their claims for principal satisfied.

The relevant Supreme Court opinion cited, *American Iron & Steel Mfg. Co. v. Seaboard Air Line Railway*, 233 U.S. 261 (1914), adopts this English exception, but like the English cases, provides no support for an independent federal right to interest. In fact, that opinion demonstrates that the only "federal rule" is a rule of distribution that permits federal bankruptcy courts in cer-

tain circumstances to allow payment of interest which has been accruing pursuant to a contract valid under state law.[10] The Court explained that the general rule refusing to allow interest after bankruptcy "is not because the claims had lost their interest-bearing quality . . . but is a necessary and enforced rule of distribution . . . ." *Id.* at 266. Since interest continued to run, "in the rare instances where the assets ultimately proved sufficient for the purpose, . . . creditors were entitled to interest accruing after adjudication." *Id.* at 267. In order to determine if there were any "interest accruing" on the claim before it, the Court looked to governing Virginia law and concluded that state law would allow interest on such a claim. *Id.* at 265.

The two other cases cited in the decision below as support for the supposed general federal rule, *see* App. A at 15a, are of no possible relevance.[11]

The court of appeals' decision is also inconsistent with two other lines of bankruptcy cases. One such line consists of those cases that have allowed the payment of post-petition interest when the collateral securing a claim is sufficient to satisfy payment of both the pre-petition claim and post-petition interest. *See Coder v.*

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[10] *Cf.* 3A Collier on Bankruptcy ¶ 63.16 [3] at 1870.1 (14th ed. 1975) ("The rate of interest depends upon the contract and the applicable state law as to usury and the legal rate of interest").

[11] In *United States v. Bass*, 271 F.2d 129 (9th Cir. 1959), the Court of Appeals for the Ninth Circuit held that the United States was not entitled to post-bankruptcy interest on a tax claim supported by a lien prior to the filing of the petition in bankruptcy. This holding is clearly irrelevant, and the opinion below apparently cites *Bass* only because, in passing, the *Bass* court referred, *id.* at 130, to the solvency exception, discussed above. Similarly, *Littleton v. Kincaid*, 179 F.2d 848 (4th Cir.), *cert. denied*, 340 U.S. 809 (1950), provides no support for the decision below, since the issue there was the date to which interest on interest-bearing notes should be allowed, *id.* at 852, and not whether bankruptcy proceedings created an independent right to interest.

Arts, 213 U.S. 223, 245 (1909).[12] This Court's opinions have consistently stated that the nature of the underlying claim determines whether, and at what rate, post-petition interest will be paid on such a secured claim. *See, e.g., Ecker v. Western Pacific Railroad*, 318 U.S. 448, 455 (1943).[13] The court of appeals' decision is also at odds with the federal bankruptcy treatment of claims based on contracts allegedly usurious under state law. Where claims arising under such contracts have been made, the courts have looked to state law to determine whether to allow such claims in bankruptcy and whether, if allowed, they bear interest.[14] This rule led the Second Circuit to hold that where governing state law provided that a mortgagee who had engaged in a usurious transaction could recover only its principal with no payment of interest, bankruptcy law would follow state law and no interest would be allowed. *Speare v. Consolidated Assets Corp.*, 367 F.2d 208 (2d Cir. 1966).[15]

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[12] *See also Palo Alto Mutual Savings & Loan Ass'n v. Williams*, 245 F.2d 77 (9th Cir. 1957); *Eddy v. Prudence Bonds Corp.*, 165 F.2d 157 (2d Cir. 1947), *cert. denied*, 333 U.S. 845 (1948).

[13] In *Ecker*, post-petition interest was paid to secured creditors at the "contract rate" on interest-bearing claims; the highest-ranking creditor of all (the Reconstruction Finance Corporation) received no interest because its Trustee's certificate did not provide for interest. *Id.* at 455. If the right to post-petition interest were indeed a "federal rule," the top-ranking secured creditor would always be entitled to post-petition interest before lower-ranking creditors were paid. Similarly, *Ticonic National Bank v. Sprague*, 303 U.S. 406, 410 (1938), held that where a depositor with a valid lien was otherwise "entitled to interest as damages for the failure to pay that balance upon demand . . . [t]he bank's obligation . . . is not cut off by suspension of its business and receivership." This Court never intimated that the right to interest arose as an incident of the bankruptcy proceeding.

[14] *See* 3A Collier on Bankruptcy, *supra*, ¶ 63.07 [15], at 1822-24.

[15] The mortgagee in *Speare* sought payment of its principal with "legal interest," the debtor having been in bankruptcy for five years. In rejecting the claim to post-petition interest because it would not be allowed under governing state law, the court never

In sum, as both the English and the American cases make clear, in the limited circumstances where post-petition interest may be paid in bankruptcy, the creditor has a right only to such interest as is allowed under applicable state law. Absent a right valid under state law, there is no federal right to receive interest from the estate of a bankrupt, even when the bankrupt proves solvent. Once the court below determined that governing state law barred the claimed payments of interest on unpaid installments of interest, the court's inquiry should have ended. By awarding the debentureholders interest on unpaid interest—something that was barred under governing state law—the court of appeals improperly intruded into an area of the law reserved to the states.

B. This Court's Decisions in Absolute Priority Rule and Other Cases Confirm That There Is No Overriding Federal Right to Post-Petition Interest.

This Court has held on numerous occasions that for a plan of reorganization under Chapter X or similar statutory provisions to be fair and equitable, it must adhere to the absolute priority rule set down by this Court in *Northern Pacific Railway v. Boyd*, 228 U.S. 482 (1913). The rule stands for the proposition that " 'any arrangement of the parties by which the subordinate rights and interests of the stockholders are to be secured at the expense of prior rights' of creditors 'comes within judicial denunciation.' " *Consolidated Rock Prod. Co. v. DuBois*, 312 U.S. 510, 527 (1941). *Accord, Case v. Los Angeles Lumber Prod. Co.*, 308 U.S. 106, 116 (1939).

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hinted that because the creditor had a valid pre-petition claim to its principal, there was an alternative federal right to post-petition interest where barred by state law. *See also Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co.*, 626 F.2d 401 (5th Cir. 1980), *modified*, 642 F.2d 744 (5th Cir. 1981) (state usury law the critical determinant of the validity and enforceability of the claim, and of the appropriate remedy).

The debentureholders asserted below that the supposed federal right to post-petition interest arose as an incident of the absolute priority rule.[16] But that rule cannot be the source of any such right. The sole purpose of the absolute priority rule is to rank creditors and equity interests in descending order of priority and to require that before payments are made to holders of lower-level interests, those with superior interests receive full satisfaction of their claims.[17] And the claims which the absolute priority rule requires to be satisfied arise from applicable nonbankruptcy law. As this Court stated in *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 161 (1946):

> "What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed is a question which, in the absence of overruling federal law, is to be determined by reference to state law."[18]

The powerful concurring opinion of Justice Frankfurter fully agreed with this analysis.

> "Obligations to be satisfied out of the bankrupt's estate thus arise, if at all, out of tort or contract or other relationship created under applicable law. And

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[16] O.C. Associates maintained in the court of appeals that the "prime issue is whether the [absolute priority] rule" required the payment of post-petition interest on unpaid pre-petition interest. Brief of O.C. Associates at 1-3. *See also* Brief of Bankers Trust at 8; Brief of Debentureholders' Protective Committee at 14.

[17] *See* 6 Collier on Bankruptcy, *supra*, ¶ 9.08, at 1570 (the absolute priority rule requires that creditors receive full compensatory treatment "for the entire bundle of rights they surrender."). If no right to interest on interest exists under applicable law, there is no right to "surrender" and no claim to satisfy under that rule.

[18] The court of appeals pointed to no provision of the Bankruptcy Act or any other statute as indicating that Congress had enacted any "overruling federal law" intended to supplant governing state law. As shown in Section IV *infra*, there are substantial reasons why state law should determine this issue.

> the law that fixes legal consequences to transactions is the law of the several States." *Id.* at 169 (Frankfurter, J., concurring).

The absolute priority rule is a rule of distribution, not a rule that creates substantive rights.[19] The absolute priority rule cases are, however, relevant to the debentureholders' claim here in one crucial respect. Since the absolute priority rule requires the full satisfaction of superior claims, if there were a "general rule of federal bankruptcy law" requiring the payment of post-petition interest, its existence presumably would be reflected in this Court's opinions discussing that rule. The principal cases elucidating the absolute priority rule show, however, that there is no such "general rule." In *Consolidated Rock Products, supra*, the interest awarded to the bondholders was determined not by federal bankruptcy law, but by the terms of their indenture.[20] Most significantly, although interest on the outstanding bonds had been in default for approximately seven years, no provision was made for payment of interest on the accrued and unpaid interest, matured or unmatured.[21] Similarly, in *Ecker v.*

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[19] "[T]he [absolute priority] rule controls the *payment* of allowable interest, not the determination of what interest is allowable." *In re New York, New Haven and Hartford R.R.*, 4 B.R. 758, 799 (D. Conn. 1980) (emphasis in original).

[20] *See* 312 U.S. at 514-15.

[21] The decisions of both the court of appeals and of this Court proceeded on the assumption that those decisions applied whether or not the debtor proved to be solvent. *See* 312 U.S. at 527; 114 F.2d at 107. In that case this Court awarded only simple interest at the contract rate on the outstanding principal. The amount of interest that the Court protected was equal to the number of years between the last payment of interest on the bonds and the effective date of the plan, multiplied by the product of the stated interest rate (6%) and the principal amount of the bonds outstanding. *See* 312 U.S. at 514-15. This demonstrates that the Court applied the absolute priority rule only to simple interest on the principal, with no award of interest on either pre-petition or post-petition accrued and unpaid interest.

Western Pacific Railroad, *supra*, 318 U.S. at 455, the post-petition interest awarded on the allowed claims was computed at the "contract rate." Thus, where the contract underlying the highest-ranking claim did not provide for interest, none was allowed.[22] The plan approved in *Ecker*, therefore, is also inconsistent with the overriding "general rule" found by Judge Wyzanski.[23]

The court of appeals claimed to find support for its "general rule" in this Court's opinion in *Vanston Bondholders Protective Comm. v. Green*, *supra*. App. A at 15a. But *Vanston* could not provide support for any such "rule." Because the debtor in *Vanston* was insolvent, this Court declined to order any post-petition interest on interest, even though provided by contract and even assuming that it were permitted by state law. 329 U.S. at 166-67. In reaching that decision, this Court confirmed that while the decision whether to *allow* interest is a matter of federal law, there is no claim to interest for a federal court to allow or disallow unless it arises under governing state law.

This two-step analysis is clear from this Court's treatment of the claim in *Vanston*. The first step there was disposed of by "assuming, *arguendo*, that the obligation for interest on interest is valid under" state law. 329 U.S. at 162. The second step was necessary, this Court said, because even if the obligation were valid under state law, "we would still have to decide whether *allowance* of the claim would be compatible with the policy of the Bankruptcy Act." *Id.* (emphasis added). As put by Jus-

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[22] In *Ecker*, the Court approved a plan under which no interest at all was allowed on a claim based on a noninterest-bearing Trustee's certificate, even though the claimant, the Reconstruction Finance Corporation, held a lien "on the entire estate." 318 U.S. at 455.

[23] *See* 6 Collier on Bankruptcy, *supra*, ¶ 9.08, at 1570-71 (the interest which accrues is that "fixed by contract or by the applicable local law") (footnote omitted).

tice Frankfurter, "We do not reach considerations of policy in bankruptcy administration until there are rights, created by local applicable law, to be recognized." *Id.* at 171 (concurring opinion).[24]

Thus, there is simply no precedent in the absolute priority rule cases or the other leading opinions of this Court for any such overriding "general rule" permitting or requiring the payment of post-petition interest, or, *a fortiori*, interest on such interest,[25] except where the creditor is entitled to such payments pursuant to a contract valid under state law. The court of appeals' award of interest barred by state law has taken from the shareholders what is theirs by right and improperly given it to the debentureholders.

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[24] *See Northern Pipeline Construction Co. v. Marathon Pipeline Co.*, —— U.S. ——, 50 U.S.L.W. 4892, 4901 n.36 (U.S. June 28, 1982) (plurality opinion) (*adjustment* of rights in bankruptcy is matter of federal law). Even if the right to post-petition interest could be construed as arising under federal law, no federal reason exists for overriding the different laws of the different states. As shown in Section IV.A. *infra*, there are substantial reasons for federal courts to adopt state laws as their rule of decision in this area even if the source of the right is federal law. Such a policy of deference to property interests defined by state law has been followed by this Court in similar contexts. For example, in *United States v. Kimbell Foods, Inc.*, 440 U.S. 715 (1979), this Court considered whether consensual liens arising from federal loan programs took precedence over private liens. While finding that the source of the law was federal, the Court adopted applicable state law for establishing priorities. *Id.* at 718. Expressing great concern about overriding "intricate state laws of general applicability," *id.* at 729, the Court concluded that, "[b]ecause the ultimate consequences of altering settled commercial practices are so difficult to foresee, we hesitate to create new uncertainties, in the absence of careful legislative deliberation." *Id.* at 739-40.

[25] "The general rule . . . is that in the absence of a contract therefor or some statute, compound interest is not allowed to be computed on a debt." *Cherokee Nation v. United States*, 270 U.S. 476, 490 (1926).

II. EVEN IF THERE WERE SUCH A "GENERAL RULE OF FEDERAL BANKRUPTCY LAW," IT WOULD HAVE TO BE LIMITED TO INTEREST ON UNPAID INTEREST INSTALLMENTS THAT BECOME DUE BEFORE THE BANKRUPTCY PROCEEDINGS BEGIN AND WOULD NOT APPLY TO INTEREST ON INTEREST INSTALLMENTS THAT BECOME DUE THEREAFTER.

Even if there were a "general rule of federal bankruptcy law" creating a right to interest on interest, the Bankruptcy Act and the Bankruptcy Code make clear that this rule could not produce a right to interest on installments of interest that did not mature until after the filing of the petition in bankruptcy. In fact, in their appeals to the court of appeals, the bulk of the debentureholders sought post-petition interest on the unpaid *pre-petition* installments of interest only.[26] The court of appeals, however, applied its overriding "general rule" to produce not just the interest that these debentureholders sought, but also post-petition interest on each installment of interest that came due *during* the bankruptcy proceedings. The court did this by reading the proofs of claim filed in April 1976 to include claims for each post-petition installment of interest, even though those installments were not then due, and awarding interest on each of those installments from the date that it came due. "General rule" or no "general rule," what the court of appeals did in creating a right to interest on installments of interest that matured *during* the reorganization proceeding is simply wrong.[27]

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[26] Post-petition simple interest on principal, accruing pursuant to state law, was provided by the plan and was never at issue.

[27] Because entitlement to post-petition simple interest is unquestioned, the court's inclusion of post-petition installments of interest on the principal *in* the claim, rather than treating them as interest *on* a claim to the principal, may at first seem an unimportant technicality. However technical, this error more than doubled the stakes here. By producing post-petition interest on post-petition interest, it increased the amount at issue from approximately $3 million

There are at least three separate grounds for rejecting this portion of the lower court's opinion. First, the proof of claim itself did not include a claim for the unmatured installments of interest that were not owing at the time of the filing of the petition. The proof of claim was quite explicit and consisted of a claim for the principal and for the "interest due and unpaid as of April 30, 1976," the date of the filing of the petition. J.A. 363-65.[28] Second, the court's treatment misreads the Bankruptcy Act, which specifically limits allowance of claims based on a fixed liability to those "absolutely owing at the time of the filing of the petition . . ., with any interest thereon which would have been recoverable at that date . . . ." Section 63a(1), 11 U.S.C. § 103(a)(1) (1976). The post-petition installments of interest certainly were not recoverable at the time of the filing of the petition and thus were not an allowable claim.[29] The new Bankruptcy Code supports

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(App. A at 6a-7a) to an amount calculated by counsel to the Trustee to be approximately $6.6 million for the straight debentures alone.

[28] The court of appeals conceded that it could find post-petition interest to be included in the proof of claim only by engaging in a "liberal interpretation" of the language of the proof of claim. App. A at 13a n.5, 16a. O.C. Associates, holding a majority of the straight debentures, did not even claim a right to interest on the post-petition installments of interest in its brief on appeal, Brief of O.C. Associates at 5-6, nor did Bankers Trust, the indenture trustee. Brief of Bankers Trust at 6. Only the Debentureholders' Protective Committee made any claim to such interest payments. It based its claim on state law, a basis clearly rejected by the court of appeals, (App. A at 14a-15a), and on the absolute priority rule, which cannot be the source of any such right, *see* pp. 13-15 *supra*.

[29] *See In re Oklahoma Ry.*, 61 F. Supp. 96 (W.D. Okla. 1945). Not even in the case of judgments obtained post-petition and incorporating interest is interest accruing between the petition and the judgment allowable. Act, § 63a(5). Nor can unmatured interest be allowed as within Section 63a(8), covering "contingent debts and contingent contractual liabilities." To hold otherwise would render the bar to unmatured interest in Sections 63a(1) and 63a(5) a nullity. Moreover, New York's highest court has said that "[u]nearned interest to become due in the future is not a debt." *Continental Securities Co. v. New York Central & Hudson River R.R.*,

this conclusion by specifically providing that a court shall disallow a claim to the extent it is for "unmatured interest." 11 U.S.C. § 502(b)(2) (Supp. III 1979).[30] Finally, the court of appeals did not cite a single case supporting its award of interest on unmatured interest, and its decision is contrary to the decisions of this and other courts.[31]

The extension by the court of appeals of its "general rule" to require not only the payment of interest on unpaid pre-petition interest but also the payment of interest

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217 N.Y. 119, 111 N.E. 484, 486 (1916) (Cardozo, J.). *Cf. In re Tastyeast, Inc.*, 126 F.2d 879 (3d Cir.), *cert. denied*, 316 U.S. 696 (1942) (where a note provided for post-maturity increased interest, note matured post-petition, and debtor erroneously believed contingent obligations not provable and allowable, the court accepted debtor's argument that it was a contingent obligation but held it unenforceable as a penalty).

Section 106(1) of the Act, 11 U.S.C. § 506(1), which defines Chapter X claims to include claims not "provable under section 63," leads to no different result. Since the unmatured interest was not a debt owed at the time the petition was filed, its inclusion in a proof of claim would have been disallowed under Section 196, 11 U.S.C. § 596, on the ground that there was "no valid claim." *See* 6 Collier on Bankruptcy, *supra*, ¶ 9.05, at 1544 (footnote omitted).

[30] Although the provisions of the Code do not apply to this case, *see* Bankruptcy Reform Act of 1978 § 403(a), 11 U.S.C. prec. 101 (Supp. II 1978), the legislative history of the Code clearly states that Congress understood the Code treatment of unmatured interest as simply codifying existing law: "Section 502(b) . . . contains two principles of present law. First, interest stops accruing at the date of the filing of the petition, because any claim for unmatured interest is disallowed under this paragraph." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 353 (1977).

[31] *See, e.g., Consolidated Rock Prod. v. Du Bois, supra*; *Ecker v. Western Pacific Railroad, supra*; *Empire Trust Co. v. Equitable Office Building Corp.*, 167 F.2d 346 (2d Cir. 1948) (discussed in note 33 *infra*). *See also American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., supra*, at 265 (question certified: "Is interest recoverable *on* such a claim for the period of the receivership?") (emphasis added); *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R.R.*, 318 U.S. 523, 535 n.7 (1943) (claims include principal and pre-petition interest; interest on claims considered separately).

on each installment of interest falling due during the bankruptcy proceeding demonstrates the far-reaching impact of its opinion. This Court should grant certiorari to review this unprecedented and significant decision.

III. THE COURT OF APPEALS' DECISION CONFLICTS WITH THIS COURT'S HOLDING IN *BUTNER* v. *UNITED STATES* AND WITH TWO DECISIONS OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

A. *Butner* v. *United States* Establishes That the Bankruptcy Laws Look to State Law in Determining the Validity of Post-Petition Claims.

The court of appeals conceded that pre-petition "interest is governed by state law, absent an overruling federal law." App. A at 8a. When it came to post-petition interest, however, the court stated that "federal not state law determines in a bankruptcy case whether a creditor is entitled to post-petition interest on a valid pre-petition claim." *Id.* at 15a.

In making this distinction, the court of appeals apparently believed that claims based on facts existing *after* the date of the filing of the petition were to be governed by federal law. In reaching this conclusion, the court below totally ignored this Court's recent decision in *Butner v. United States*, 440 U.S. 48 (1979).[22] *Butner* also concerned an alleged "federal rule" allowing post-petition claims nonexistent under applicable state law. A mortgagee there claimed a right to recover rents collected after the petition in bankruptcy was filed, even though under state law he was not entitled to the rents because he had not foreclosed on the property. The courts of appeals had split on the issue, with five courts holding that an award could only be made if state law permitted,

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[22] Petitioners explicitly brought *Butner* to the court's attention. *See* Brief for Appellees Glen Corporation, M. Wallace, N. Wallace, Minority Stockholders Committee, at 16-18; *cf.* Reply Brief of O.C. Associates, at 6-7.

and two courts holding that federal bankruptcy law alone governed such post-petition claims. *Id.* at 52-53.

This Court, in an opinion by Justice Stevens, unanimously rejected the holding of the two courts of appeals that had "adopted a federal rule of equity" giving a mortgagee a secured interest in post-petition rents "even if state law would not recognize any such interest until after foreclosure." *Id.* at 53 (footnote omitted). This Court rejected that approach because, "at least in some circumstances, [it] affords the mortgagee rights that are not his as a matter of state law. The rule we adopt avoids this inequity because it looks to state law to define the security interest of the mortgagee." *Id.* at 56. The Court held that state law would determine the mortgagee's rights and affirmed the lower court's decision that barred the creditor's claim because it was not valid under applicable state law.

Petitioners argued below that the claims of the creditor in *Butner* are indistinguishable from the claims made by the debentureholders here. The vast majority of the debentureholders abandoned any claim under state law and, like the mortgagee in *Butner*, relied entirely on an alleged federal right; the same is true of the court of appeals itself, which found no right arising under state law. The failure of the court of appeals even to mention, let alone distinguish, *Butner* clearly indicates the need for this Court to reinforce its holding in that case.

B. The Second Circuit Has Twice Rejected the Same Claims That Were Upheld By the Court of Appeals Here.

The decision below is flatly contrary to two decisions of the United States Court of Appeals for the Second Circuit, which firmly rejected the award in Chapter X proceedings of interest on overdue interest payments where barred by governing state law. This Court should grant certiorari in order to resolve this clear conflict between circuits.

This issue was first presented to the Second Circuit in *In re Realty Associates Securities Corp.*, 163 F.2d 387 (2d Cir.), *cert. denied*, 332 U.S. 836 (1947). The creditors there sought payment of interest from a solvent debtor on the portion of their claim which represented unpaid pre-petition interest. Like the creditors here, they did not rely on any express contract claim to such interest since their indenture made no provision for interest on interest. The court in *Realty* found that interest on unpaid interest was not payable under New York law and, rejecting various equitable theories also put forward by the creditors, denied their claim.

This issue was again presented to the Second Circuit approximately one year later in *Empire Trust Co. v. Equitable Office Building Corp.*, 167 F.2d 346 (2d Cir. 1948). In an opinion by Judge Swan (Judges L. Hand and Frank concurring), the court considered a claim in bankruptcy seeking payment from a solvent debtor of interest on outstanding overdue and unpaid interest coupons. After a careful study, the court determined that the claim was not valid under applicable New York law. That determination ended its review of the claim, the court said, "since we have already decided that the promise to pay interest on interest created no valid obligation to holders of unnegotiated coupons." *Id.* at 349.[33]

Thus, the Second Circuit holds that the allowance of a claim for interest on interest is to be considered in reor-

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[33] *Empire Trust* is also inconsistent with the ruling of the Court below that interest must be paid on each post-petition installment of interest. Even though the debtor there had failed to pay six years of semi-annual interest payments, no interest was paid on the unpaid post-petition installments of interest. Both *Realty Associates* and *Empire Trust* were recently discussed and distinguished by the Second Circuit in *Corbin v. Federal Reserve Bank*, 629 F.2d 233, 237-38 (2d Cir. 1980), *cert. denied*, 450 U.S. 970 (1981); *cf. Ruskin v. Griffiths*, 269 F.2d 827, 830 (2d Cir. 1959), *cert. denied*, 361 U.S. 947 (1960) (distinguishing *Empire Trust* and upholding variable interest rate provision against solvent debtor where valid under state law).

ganization only if it is valid under state law.[34] The First Circuit holds that such a claim, invalid under state law, can be allowed under an overriding "general rule of federal bankruptcy law." This Court should grant certiorari to resolve this conflict between the circuits.

IV. THE CREATION OF A "GENERAL RULE OF FEDERAL BANKRUPTCY LAW" IMPROPERLY INFRINGES ON STATE COMMERCIAL LAW AND WILL ENCOURAGE THE FILING OF ADDITIONAL BANKRUPTCY CASES.

A. This Court and Other Courts Have Repeatedly Held That Bankruptcy Law Will Recognize State Laws Governing Commercial Transactions.

As this Court recently noted, while "Congress has power to enact bankruptcy laws that are uniform throughout the United States," a uniform bankruptcy law "'may recognize the laws of the State in certain particulars, although such recognition may lead to different results in different States.'" *Railway Labor Executives' Association v. Gibbons*, — U.S. —, 102 S. Ct. 1169, 1176 (1982) (*quoting Stellwagen v. Clum*, 245 U.S. 605, 613 (1918)). Thus, "uniformity does not require the elimination of any

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[34] *Accord, In re Georgia, Florida, and Alabama R.R.*, 88 F. Supp. 796 (M.D.Ga. 1950) (New York law; provision void, and per *Vanston*, would not be allowed if valid). *See also In re International Hydro-Electric System*, 32 S.E.C. 504, 512 (1951) (noncontractual claim for interest on interest on interest not enforceable under Massachusetts law; claim denied); this issue was not raised on appeal to the district court, *see In re International Hydro-Electric System*, 101 F. Supp. 222, 225 (D. Mass. 1951). The Second Circuit's approach was also employed by the district court in *In re Norcor Mfg. Co.*, 36 F. Supp. 978 (E.D. Wis. 1941). The court there considered a claim for interest on an interest claim that a master had allowed in an earlier state receivership proceeding. The court noted that the underlying contract did not provide for such interest, found that there "is no statutory authority for allowing compound interest on claims that are allowed in bankruptcy," and concluded that "all that the creditor is entitled to is the face of his claim, plus accrued interest . . . ." *Id.* at 980.

differences among the States in their laws governing commercial transactions." 102 S. Ct. at 1176.

Congress has recognized these "differences among the States" by providing that "no obligation finds its way into a bankruptcy court unless, by the law of the State where the acts constituting a transaction occur, the legal consequence of such a transaction is an obligation to pay," *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 170 (1946) (Frankfurter, J., concurring).[35] This is merely one aspect of the more sweeping policy under which "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law," *Butner v. United States*, 440 U.S. 48, 54 (1979). As this Court stated in *Butner:*

> "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.' *Lewis*

[35] The differences among the states recognized by this Court in *Butner* and *Railway Labor Executives* have been respected in analogous situations where the payment of interest has been at issue. For example, the Miller Act, 40 U.S.C. §§ 270a-d (1976), provides a cause of action, in lieu of state statutory mechanics' liens, for subcontractors on federal government construction projects. While the allowance of prejudgment interest has been held to be a matter of federal law, the Fifth Circuit looked to state law " 'as a matter of convenience and practicality' " in deciding whether it would be awarded in that case. *United States ex rel. Georgia Electric Supply Co. v. United States Fidelity & Guaranty Co.*, 656 F.2d 993, 996-98 (5th Cir. 1981). And under the federal interpleader statute, 28 U.S.C. § 1335 (1976), it has been held that where governing state law did not permit the award of prejudgment interest, none would be awarded by the federal courts. *Perkins State Bank v. Connolly*, 632 F.2d 1306, 1319-20 (5th Cir. 1980).

v. Manufacturers National Bank, 364 U.S. 603, 609." 440 U.S. at 55.

The court's decision has significant implications for state commercial relations. A number of states either totally disallow the payment of interest on unpaid interest or permit such payments only if expressly provided for by contract.[36] These laws reflect the states' concern about the effect that compound interest can have on even relatively small claims. All of these laws are rendered meaningless after bankruptcy by the court's decision creating a federal right overriding them. The same is true of the many state laws which bar creditors with usurious contracts from collecting interest on those contracts; if there is a federal right to interest, those creditors could collect post-petition interest barred by state law.[37] But there

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[36] Georgia: *Grant v. Fourth Nat'l Bank of Columbus*, 229 Ga. 855, 194 S.E.2d 913, 919 (1972). Idaho: Idaho Code § 28-22-106 (1948). Missouri: Mo. Ann. Stat. § 408.080 (Vernon 1953); *Sloan v. Paris*, 541 S.W.2d 316, 321 (Mo. Ct. App. 1976). Nebraska: *Abbott v. Abbott*, 188 Neb. 61, 195 N.W.2d 204, 209 (1972). New Jersey: *Abramowitz v. Washington Cemetery Ass'n*, 139 N.J.Eq. 293, 51 A.2d 461, 463 (N.J. Ch. 1947). New Mexico: *Southern Union Exploration Co. v. Wynn Exploration Co.*, 95 N.M. 594, 624 P.2d 536, 543 (Ct. App.), *cert. denied*, 95 N.M. 593, 624 P.2d 535 (1981), *cert. denied*, —— U.S. ——, 102 S.Ct. 1276 (1982). Pennsylvania: *Murray v. Prudential Ins. Co.*, 144 Pa. Super. 178, 18 A.2d 820 (1941); *Powell v. Retirement Bd.*, 431 Pa. 396, 246 A.2d 110 (1968). Washington: *Goodwin v. Northwestern Mut. Life Ins. Co.*, 196 Wash. 391, 83 P.2d 231, 238 (1938).

[37] At least eleven states bar creditors holding usurious contracts from collecting interest on their debt, although permitting the creditors to recover their principal. *E.g.*, Ala. Code § 8-8-12 (1975); D.C. Code Ann. § 28-3303 (1981); Fla. Stat. Ann. § 687.04 (West 1966 & Supp. 1982); Ga. Code Ann. § 57-112 (1977); Iowa Code Ann. § 535.5 (West 1950); La. Rev. Stat. Ann. § 9:3501 (West 1951 & Supp. 1981); Mich. Stat. Ann. § 19.15(2) (Callaghan 1981); Miss. Code Ann. § 75-17-1 (1972 & Supp. 1981); Neb. Rev. Stat. § 45-105 (1978); N.J. Stat. Ann. §§ 31: 1-3, 31: 1-4 (West 1963 & Supp. 1981); Va. Code § 6.1-330.45 (1979 & Supp. 1982). Those creditors would have a "claim" in bankruptcy for their principal, on which the court of appeals' decision apparently would award inter-

is no reason underlying the bankruptcy laws that justifies overriding state policy simply because a borrower voluntarily or involuntarily ends up in bankruptcy proceedings. The decision of the court below achieves just the result this Court intended to prevent—" 'a windfall merely by reason of the happenstance of bankruptcy.' "

B. The Court of Appeals' Decision Will Encourage Creditors to Improve Their Positions by Resort to the Bankruptcy Courts Under the New Bankruptcy Code.

The lower court's opinion invites creditors to use the bankruptcy courts to improve their private contractual rights. This case illustrates the point. Under the exchange offer, most of the convertible debentures were traded for straight debentures, at a 30 or 40 percent premium. The convertible debentures provided that they would be governed by Massachusetts law, which allows interest on interest, while the straight debentures were explicitly governed by New York law, which does not. Nearly 60 percent of the straight debentures, in fact, are held by O.C. Associates, which acquired all its debentures *after* the Chapter X filing and *after* the default on the pre-petition interest (J.A. 369-70), presumably paying a price reflecting the effect that New York law would have on any recovery. While the court of appeals recognized the difference in the law governing the two debentures, it reached the same result despite that difference. App. A at 15a-16a.[38]

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est that could not be collected in state court. Yet, as the Fifth Circuit has stated in invalidating a claim because it was usurious under state law, "the determination of whether usury prevents enforcement of the claim should not vary depending upon whether the defense is raised in a state or instead a federal court of the forum [state]." *Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., supra*, 642 F.2d at [illegible] n.8.

[38] The convertible debentureholders argued, in fact, that the payment of a 30 to 40 percent premium to the straight debentureholders was a sufficient reason to treat the two debentures differently on this issue. Brief of First National Bank of Boston at 5 n.

There is no policy in the bankruptcy laws for failing to recognize such differences.[39] As the Second Circuit recently stated in enforcing contract clauses, valid under state law, that permitted creditors to recover collection costs and liquidated damages, bankruptcy law should recognize "the bargained-for terms of the loan contract." *United Merchants & Manufacturers v. Equitable Life Assurance Society*, 674 F.2d 134, 137 (2d Cir. 1982).

If creditors can improve the explicit terms of their loan contracts by resort to a bankruptcy court, they have an incentive to bring bankruptcy proceedings instead of relying on negotiated arrangements. At a minimum, the court of appeals offers an incentive to a creditor whose contract does not provide for interest on interest to start bankruptcy proceedings if the debtor is likely to prove solvent or the creditor's collateral is sufficient to cover payment of interest on interest. The same applies to creditors under contracts for usurious interest where state law bars the recovery of any interest under such a contract. Beyond this, the court of appeals' decision may also provide an incentive to start bankruptcy proceedings to creditors whose contractual rate of interest is below the "statutory general rate," App. A at 15a, wholly apart from any question of interest on interest. This possibility arises because the decision suggests that creditors may rely *either* on their contracts *or* on their supposed federal right to interest, at their election.[40] The bankruptcy

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[39] The equitable powers of a bankruptcy court to, *e.g.*, subordinate claims are unquestioned, but are not relevant here. The court of appeals did not purport to rearrange rights on equitable grounds. Rather, it purported to find claims based on federal law. Only after finding those claims did it address the equitable question of whether those claims must be paid.

[40] The decision nowhere says whether contractual provisions bar resort to the supposed federal right. However, the indenture governing the straight debentures provided for interest on interest "to the extent permitted by law," § 7.02 of the 1973 Indenture (J.A. 311), *quoted in* App. A at 4a-5a; since New York law did not allow any interest on interest, the contractual rate for interest on inter-

court could thus become a board of contract relief for creditors whenever their contract rates are below the legal rate.

The court of appeals' decision would appear to apply not only to the former Bankruptcy Act but also to the new Bankruptcy Code. Section 506(b) of the Code, 11 U.S.C. § 506(b) (Supp. III 1979), embodies the traditional rule that if the value of the security is sufficient, secured creditors receive interest. It provides simply for "interest on such [allowed secured] claim . . . ." [41] While this Court's opinions have limited secured creditors to their contractual interest rate in such circumstances,[42] the court of appeals' decision would appear to give creditors a choice between their contract rate and the rate under the "general rule," whichever is higher. If the contract provides for interest on interest and that provision is invalid under state law, the creditor would also appear to have a right to receive interest on interest as a matter of federal law, just as the straight debentureholders were awarded such a right here.[43] And if the approach

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est was, in effect, zero percent. Most of the straight debentureholders chose not to rely on their contract in claiming interest on interest, and the court permitted them (as well as the straight debentureholders who did rely on their contract) to recover interest on interest at the noncontractual rate of 8 percent. Thus, the court permitted the creditors to choose between federal and state law.

[41] This subsection reads in full:

> "(b) To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided under the agreement under which such claim arose."

[42] *See* pp. 10-11 above.

[43] That portion of the court's decision awarding interest on each installment of interest maturing during the bankruptcy proceeding would also appear to apply to claims arising under the new Bankruptcy Code, with the same significant consequences as it had in this case. *See* note 27 *supra*.

taken by the court of appeals controls, then secured creditors with sufficient security could improve their positions in bankruptcy proceedings under the Code, precisely as the court of appeals' decision allows under the Act, and directly contrary to this Court's decisions in cases like *Butner*.[44]

Bankruptcy courts have more than enough work without taking on the burden of undoing contracts that contain interest rates below today's elevated legal rates, or lack interest on interest provisions valid under state law, or contain interest rates usurious under governing state law. A federal right to post-petition interest, or to interest on interest, invites creditors to seek to persuade bankruptcy courts to rewrite many of these contracts, whether under the old Act or the new Code. This Court should grant certiorari to prevent such an intrusion of the bankruptcy laws on matters governed by state law.

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[44] The court of appeals' decision may also affect claims of unsecured creditors under the Code. Section 726(a)(5) of the Code permits unsecured creditors to receive interest on their claims at the "legal rate" before the debtor receives any payments. It is not clear from the scant legislative history at what rate, if any, interest is to be paid where state law bars interest, since the "legal rate" for such a claim would be zero percent. If there is an alternative "federal" right to interest, then the state bar on payment of interest would have no effect.

CONCLUSION

For the reasons stated above, certiorari should be granted to review the judgment of the court of appeals.

Respectfully submitted,

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